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SUPREME COURT OF KENTUCKY
2013-SC-000598-CL

APPALACHIAN LAND COMPANY — APPELLANT

v.

UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT
NO. 12-5589

EQT PRODUCTION COMPANY — APPELLEE

On Certification of Law from the United States Court of Appeals for the Sixth Circuit

BRIEF OF APPELLANT

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CERTIFICATE OF SERVICE

This will certify that a true and correct copy of this Brief has been served by mailing same, postage prepaid, on Gregory L. Monge, Kimberly S. McCann and Keri E. Lucas, VANANTWERP, MONGE, JONES, EDWARDS & McCANN, P.O. Box 1111, Ashland, KY 41105-1111, Counsel for Appellee, EQT Production Co., on Hon. Karen K. Caldwell, Judge of the United States District Court for the Eastern District of Kentucky, 201B Federal Building, 102 Main Street, Pikeville, KY 41501, this the 18th day of July, 2014.

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APPALACHIAN LAND COMPANY CERTIFICATION BRIEF

INTRODUCTION

The United States Court of Appeals for the Sixth Circuit in a *Per Curiam* Opinion rendered August 26, 2013, a copy of which is attached hereto as Appendix A (the "Opinion"), certified to this Court a question regarding the construction of an oil and gas lease covering lands in Pike County, Kentucky, a copy of which is attached hereto as Appendix B (the "Lease"). The precise question is whether severance taxes in the amount of 4 ½ % of gross value, imposed by the Commonwealth of Kentucky pursuant to KRS 143A.010 *et seq.*, may be deducted by EQT Production Company ("EQT") in the calculation and payment of royalties due the landowner, Appalachian Land Company ("ALC"), based upon "the market price of gas at the well."

STATEMENT CONCERNING ORAL ARGUMENT

CR 76.37(6) provides oral argument will not be permitted unless so ordered by this Court. ALC is available for oral argument should the Court so request.

STATEMENT OF POINTS AND AUTHORITIES

APPENDIX

STATEMENT OF THE CASE

The question to be determined by this Court has its genesis in the 1944 Lease of oil and gas from Robert Williams, predecessor in title to Appalachian Land Company ("ALC"), to Kentucky West Virginia Gas Co., Inc., predecessor in title to EQT Production Company f/k/a Equitable Production Company ("EQT"), covering lands in Pike County, Kentucky. Opinion at 3. Gas wells have been drilled and produced from the leased premises by EQT. *Id.* The Lease provides for a royalty on natural gas "at the rate of one-eighth (1/8) of the market price of gas at the well." *Id.* In the calculation and payment of such royalty, EQT has deducted the 4.5% severance tax imposed by the Commonwealth of Kentucky. *Id.* at 5.

The Opinion states that pursuant to *Poplar Creek Dev. Co. v. Chesapeake Appalachia, LLC,* 636 F.3d 235 (6th Cir. 2011) (*"Poplar Creek"),* Kentucky follows the "at-the-well" rule[1] which permits the deduction of post-production costs prior to the calculation and payment of the landowner royalties.[2] Opinion at 2-3. "Post-production" costs are expenses "incurred <u>after</u> the gas leaves the wellhead." (Emphasis added.) Opinion at 4, quoting from *Poplar Creek.* 636 F.3d at 239. Stated differently, the lessor (ALC) must bear "its proportionate share of processing costs incurred <u>downstream of the</u>

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[1] The Opinion correctly notes that in *Poplar Creek* the meaning of "at-the-well" is based on *Piney Woods Country Life School v. Shell,* 726 F.2d 225, 240 (5th Cir. 1984), where Mississippi (and not Kentucky) law was applied. For the purpose of this appeal, the correctness of *Poplar Creek* cannot be challenged. However, this Court on June 11, 2014, granted a Motion For Discretionary Review where the appropriateness of *Poplar Creek,* as reflective of the law of Kentucky, is directly challenged, *Nobe Baker et al v. Magnum Hunter Production, Inc.,* Case Number 2013-SC-000497-DG (2012-CA-001016).

[2] The lease under consideration in *Poplar Creek* contained a provision whereby taxes on gas production were to be ratably shared. 636 F.3d at 245, note 5. Thus, severance taxes were not before the court in *Poplar Creek.*

well" by "working back" from the price at the point of sale and deducting the cost of processing and transportation after the gas leaves the wellhead. (Emphasis added.) Opinion at 4, quoting from *Schroeder v. Terra Energy, Ltd.*, 565 N.W.2d 887, 893 (Mich. Ct. App. 1997). Severance taxes are not post-production costs – such taxes are imposed on the severance of the gas "from the earth" which is part of the production process.[3] KRS 143A.010(3). Severance taxes are imposed before the gas leaves the wellhead and commences its pedestrian journey downstream to the point of sale. *Id.*

In the past, EQT and the District Court have taken the position that severance taxes should be treated as just another post-production cost to be ratably shared between the lessor and lessee. The EQT and District Court advocacy finds no support in decided case law. There is a vast difference between post-production costs and production costs such as severance taxes.

ConocoPhillips Co. v. Lyons, 299 P.3d 844, 849-850 (N.M. 2012), sets forth, in non-technical language, the various steps involved in the natural gas production process:

> When gas is extracted from a well, it is in a form that is not commercially merchantable. In order to be sold on the commercial market, the gas must be processed. . . . Once the gas is extracted from the ground, several processes may be necessary to transform the gas into a merchantable product. These processes include: gathering, compressing, dehydrating,[4] and treating the gas. The expenses associated with these processes are referred to as "post-production costs." *See* 8 Williams & Meyers, *supra,* at 787 (citing *Schroeder v. Terra Energy, Ltd.,* 223 Mich.App. 176, 565 N.W.2d 887, 890 (1997), which defined post-production costs as "costs associated with making the natural gas marketable after the gas is severed or removed from the ground").

[3] In *Poplar Creek* the Sixth Circuit points out that "[p]roduction costs, like those incurred in drilling, operating and maintaining a well, as well as other costs incurred in order to extract gas from the earth and bring it up to the wellhead, are borne entirely by" the lessee." (Emphasis added.) 636 F.3d at 239.

[4] For the purposes of this litigation, "dehydration" has been included as part of the treatment process.

Post-production costs commence <u>after</u> the gas has been severed and removed from the ground. *Id.* Under *Poplar Creek* there is no question that EQT is entitled to deduct the post-production costs (and only post-production costs) in the calculation of royalty due to ALC.

Costs incurred prior to the gas leaving the wellhead are labeled "production costs." *Poplar Creek* confirms production costs include "drilling . . . as well as other costs incurred in order to extract gas from the earth and bring it up to the wellhead . . . ." 636 F.3d at 239.

THE QUESTION

The question certified by the Sixth Circuit is stated as follows (the "Question"):

> Does Kentucky's 'at-the-well' rule allow a natural gas producer to deduct all severance taxes paid at market prior to calculating a contractual royalty payment based on 'the market price of gas at the well,' or does the resource's at-the-well price include a proportionate share of the severance taxes owed such that a processor may deduct only that portion of the severance taxes attributable to the gathering, compression and treatment of the resource prior to calculating the appropriate royalty payment?

With all due deference to the Sixth Circuit, the wording of the Question is somewhat cumbersome when Chapter 143A, "Natural Resources Severance and Processing Taxes," of the KRS (the "Statute") is reviewed. The act of severing and the act of processing are different. The severance tax portion of the Statute is imposed only upon the severance of the gas "from the earth." (KRS 143A.010(3); KRS 143A.020(1)). After the gas leaves the wellhead, taxes also are imposed upon the value added by processing. KRS 143A.010(5), and as amended effective July 1, 2013, KRS 143A.010(6); KRS 143A.020.

The issue at bar arises by the fact the gas is not sold at the well. In *Poplar Creek*, the gas was not sold "at-the-well" and the Sixth Circuit utilized the work back method for arriving at the "at-the-well market price." 636 F.3d at 239. If it is assumed that the work back method establishes a wellhead price of $2.00 per MCF,[5] the Question to be decided by this Court is whether the one-eighth royalty on natural gas due the landowner, ALC, should be based on the one-eighth part of $2.00 per MCF or one-eighth of $2.00 minus the 4.5% Kentucky severance tax? Mathematically, the Question is: 1/8th x $2.00 or 1/8th of ($2.00 x 95.5%)?

ARGUMENT

THE LESSEE IS NOT PERMITTED TO DEDUCT THE KENTUCKY SEVERANCE TAX IN THE CALCULATION AND PAYMENT OF GAS ROYALTIES DUE THE LANDOWNER BASED ON "MARKET PRICE OF GAS AT THE WELL."

There are two sound reasons why the Kentucky Severance Tax should not be deducted in the calculation and payment of royalties due to the landowner, ALC. First, the Statute plainly applies to the taxpayer who severs the natural gas and specifically excludes the owner of a royalty interest. Where the lease does not specifically allocate the severance tax and the royalty is based on market price or market value at the well, decided case law turns on whether or not the particular statute by definition includes the royalty owner as a party responsible for its ratable share of the tax. In the instant case, the Lease does not specifically allocate payment of the severance tax. In addition, the royalty owner (ALC) by statute is excluded from imposition of the severance tax. The Lease royalty is based upon a percentage of market price at the well. Since the Statute

[5] "MCF" is one thousand cubic, the standard unit for measuring the volume of natural gas. 8 Williams & Meyers, *Oil and Gas Law*, 625 (1995 ed.).

imposes no responsibility for tax payment upon the lessor, the lessee (EQT) is without authority to deduct the severance tax in the calculation and payment of the gas royalty due ALC under the Lease.

Secondly, although the Lease does not specifically allocate or address payment of the severance tax, the severance of natural gas from the earth is universally recognized as a part of the production process for which the lessee is responsible. The royalty by its very nature is free of production costs. Since the severance of gas is a part of the production process and the royalty is free of production costs, severance taxes cannot be deducted in the calculation and payment of the gas royalties due the landowner based upon "market price of gas at the well."

The Opinion, at pages five and six, sets out two instances where the District Court advances its reasons for holding that severance taxes may be deducted in calculation and payment of gas royalties due under the Lease. In one, the District Court mischaracterizes the severance tax as "simply another post-production cost." In the other, the District Court incorrectly perceives a difference between how the royalties were calculated and paid ALC and "market price at the well."

Lastly, should this Court determine that the Lease is ambiguous as to the party who should bear the severance tax, Section IV sets out the applicable law as to the construction of an ambiguous lease.

I. The Kentucky Severance Tax Is Imposed Solely Upon The Lessee, EQT.

The Opinion concludes: "we now certify the question of law stated above to the Kentucky Supreme Court regarding the intent and the reach of the Kentucky severance tax statute." In light of this recited purpose, the Argument begins with a discussion of the Statute.

The Statute became effective in 1980. KRS 143A.020 is entitled "Levy of natural resources severance and processing tax; application of such tax" and it provides in pertinent part:

> (1) For the purpose of severing or processing natural resources in this state, a tax is hereby levied at the rate of four and one-half percent (4.5%) on natural gas ... , such rates to apply to the gross value of the natural resources severed or processed. ...
>
> (2) The tax shall apply to all taxpayers severing and/or processing natural resources in this state, and shall be in addition to all other taxes imposed by law.

KRS 143A.010 sets out various definitions utilized in the Chapter and it provides in pertinent part:

> (2) "Natural resource" means all forms of minerals including but not limited to . . . natural gas, and natural gas liquids . . . (It does not include coal or oil which are separately taxed.)
>
> (3) "Severing" or "severed" means the physical removal of the natural resource from the earth or waters of this state by any means . . .
>
> (4) "Taxpayer" means and includes any individual, partnership, joint venture, association, corporation . . . engaged in the business of severing and/or processing natural resources in this state for sale or use. In instances where contracts . . . are entered into whereby persons, organizations or businesses are engaged in the business of severing and/or

processing a natural resource <u>but</u> do not obtain title to or do not have an economic interest therein, the party who owns the natural resource or has an economic interest is the taxpayer. (Emphasis added.)

> (5) "Gross value" is synonymous with gross income from property as defined in section 613 of the Internal Revenue Code and regulations 1.613-3 abed 1.613-4 in effect on December 31, 1977, with the exception that in all instances transportation expense . . . shall not be considered as gross income from the property. Gross value is to be reported as follows:
>
> (a) For natural resources severed and/or processed and sold during a reporting period, gross value is the amount received or receivable by the taxpayer. . .
>
> (g) In all instances, the gross value shall not be reduced by any taxes including the tax levied in KRS 143A.020, ...
>
> (6) "Processing" includes but is not limited to . . . cleaning, drying . . . .
>
> (8) "Economic interest" for the purpose of this chapter is synonymous with the economic interest ownership required by Internal Revenue Code, Section 611 in effect on December 31, 1977, entitling the taxpayer to a depletion deduction for income tax purposes <u>with the exception that a party who only receives an arm's length royalty shall not be considered as having an economic interest.</u> (Emphasis added.)

Some of the definitions utilized in KRS 143A.010 were amended effective July 1, 2013. Subsection (8), definition of "economic interest," was deleted and a major portion was included in a new paragraph (b) added to subsection (4) to read as follows:

> (4)(b) For purposes of this chapter, a taxpayer possesses an economic interest in a natural resource where the taxpayer has acquired by investment any interest in a natural resource and secures, by any form of legal relationship, income derived from the severance or processing of the natural resource, to which he must look for a return of his capital. <u>A party</u> who has no capital investment in the natural resource or <u>who only receives an arm's length royalty shall not be considered as having an economic interest.</u> (Emphasis added.)

The definition of "gross value" contained in subsection (5) deleted any reference to the Internal Revenue Code and simply provides:

(5) "Gross value" is defined as follows:

> (a) For natural resources severed and/or processed and sold during a reporting period, gross value is the amount received or receivable by the taxpayer. . . .

The amendment, effective July 1, 2013, does not change the application of KRS 143A.010 to the facts of this case. Under KRS 143A.010(4), and under KRS 143A.010(4)(a), which became effective July 1, 2013, "taxpayer" is any entity "engaged in the business of severing and/or processing natural resources . . . " There is no evidence to suggest that ALC is engaged in the business of severing and/or processing the gas. Rather, this is the activity in which EQT is engaged pursuant to the terms of the Lease. Opinion at 3.

The second and concluding sentence of Subsection (4), and (4)(a), effective July 1, 2013, confirms that where the severing entity does not obtain title to the natural resource, the party (such as a contract operator) is not the taxpayer and does not have an "economic interest." This second sentence of subsection (4) and new (4)(a) does not apply in the instant case because EQT and only EQT severs and processes the gas produced from the Lease. Opinion at 3. Without a third party who severs (or processes) the gas, the entity which has the "economic interest" is not called into question. It is not called into question in the instant factual setting.

Subsection (8) which was deleted effective July 1, 2013, and subsection (4)(b), effective July 1, 2013, use the same language and confirm that "a party who only receives an arm's length royalty shall not be considered as having an 'economic interest.'" There is no evidence that the one-eighth (1/8) royalty of ALC in the 1944

Lease is anything other than arm's length. The "landowner's royalty" traditionally is "1/8 of the proceeds received from the sale of gas." *Black's Law Dictionary*, 1445 (9th ed. 2009). Kentucky law is in accord. *Ralston v. Thacker,* 932 S.W.2d 384, 386 (Ky. App. 1996) ("the customary 1/8 [1/8 x 8/8] landowner's royalty in the event of production."); *E. H. Lester Leasing Co. v. Griffith,* 779 S.W.2d 226, 227 (Ky. App. 1989) (the oil and gas lease provides for "the payment to Griffith of the customary 1/8 royalty."). The fact that the usual royalty in oil and gas leases is one-eighth is "so generally known that judicial knowledge may be taken of it." *State Nat. Bank of Corpus Christi v. Morgan,* 143 S.W.2d 757, 761 (Tex. Comm'n App. 1940).

The Opinion concedes that EQT, as successor lessee, has severed and produced the gas. Opinion at 3. Pursuant to the Lease, EQT has paid the standard 1/8th royalty on the gas to ALC, and without authority has deducted severance taxes in the calculation and payment of such royalty. One who leases the mineral to a party who thereafter removes it from the earth is not engaged in severing such mineral. KRS 143A.010(4); see, also, *Cimmaron Coal Corp. v. Department of Revenue,* 681 S.W.2d 435, 437 (Ky. App. 1984) (where similar provision of the coal severance tax, KRS 143.010 *et seq,* were construed and the court held "a mineral owner who leases his coal to a severer of coal is not 'engaged in severing' that coal.").

To determine legislative intent, a court must refer to the words used in enacting the statute. *McDowell v. Jackson Energy RECC,* 84 S.W.3d 71 (Ky. 2002). When the statute's language is plain, the sole function of the courts is to enforce it according to its terms. *Bailey v. Reeves*, 662 S.W.2d 832 (Ky. 1984). Under the Statute, it is clear that EQT is the entity upon whom the severance tax is imposed.

Consistent with its evident plain meaning, there is a dearth of authority construing the Statute. However, for purposes of argument if there is more than one reasonable construction (which ALC denies) and there are no published decisions construing a statute within the jurisdiction, the court has mandated that "similar" statutes from this and other jurisdictions must be considered. *Brown v. Commonwealth*, 40 S.W.3d 873, 875-876 (Ky. App. 1999), see, also, *Schmitt Furniture Company, Inc. v. Commonwealth by and on behalf of Gillis of Kentucky*, 772 S.W.2d 889, 891 (Ky. 1987). Accordingly, Kentucky has decided a case involving a similar severance or production tax on oil, there are cases involving the analogous Kentucky coal severance tax (in addition to *Cimmaron*, *supra*), and there are a number of cases from other jurisdictions which have addressed the same issue under similarly worded severance tax statutes.[6] These cases are all in agreement – no part of the severance tax should be deducted in the calculation and payment of royalties due the landowner.

In *Burbank v. Sinclair Prairie Oil Co.*, 202 S.W.2d 420 (Ky. 1946), the Kentucky high court was faced with a tax, codified at KRS 137.120,[7] imposed upon "every person, firm, corporation and association engaged in the business of producing oil in this State,

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[6] Where the statute under consideration expressly provides for inclusion of the royalty owner as a party responsible for payment of such severance tax, the courts routinely have held such royalty owner responsible for his ratable share of such tax. See, e.g., *Cartwright v. Cologne Production Co.*, 182 S.W.3d 438 (Tex. App. 2006). Conversely, in the instant case the tax is imposed on the party who "severs" the gas (KRS 143A.020(2) and excludes the royalty owner (KRS 143A.010(8), prior to July 1, 2013, and KRS 143A.010(4)(b), after July 1, 2013.)

[7] This Court recognizes the similarity between KRS 137.120, the coal severance tax (KRS 143.010 *et seq*), and the natural resource severance tax in KRS 143A.010 *et seq*. *Gillis v. Yount*, 748 S.W.2d 357, 358 (Ky. 1988) ("Under KRS 137.120 a similar tax is imposed upon 'all crude petroleum produced in this state.'").

by taking same from the earth, . . ." *Id.* at 422. *Burbank* points out that the tax under consideration is a tax upon the "severing and producing of oil." *Id.* at 424. The issue, which is identical to the Question in the instant case, was whether the lessee had to pay the entirety of the tax or could deduct 1/8th from the royalty due the landowner. *Id.* The royalty due Burbank was based on "the equal 1/8 part of all oil produced and sold."[8] *Id.* at 421. The amount upon which the tax was levied was "worked-back" from the price at which the product was sold in the market place in order to arrive at the market price where the crude oil was first transported from the well site tank battery to the pipeline to market. *Cumberland Pipe Line Co. v. Commonwealth,* 15 S.W.2d 280 (Ky. 1929).

Burbank points out that Arkansas, Louisiana, Michigan, Oklahoma, Mississippi and Texas all have taxes on the production of oil. *Id.* at 424. After examining the law of these specified states, the *Burbank* court found:

> In other States having similar acts, and which do not define the word "Producer" or where the Act does not make the lessor proportionately liable, the courts have held the tax not to extend [to the lessor royalty owner]. (Citations omitted.)

Id. The court concluded "the original act as amended cannot be construed as placing any part of the tax in question on one who is simply [a] royalty owner." *Id.* at 425. In reaching its conclusion, the *Burbank* court correctly observes that should the facts show a joint venture between the lessor and lessee or should the act impose joint liabilities, the result could change. *Id.* at 423-424. Neither the Statute nor the Lease changes the underlying facts on which *Burbank* is premised – the Lease does not create any joint

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[8] *Warfield Natural Gas Co. v. Allen,* 88 S.W.2d 989, 992 (Ky. 1935), established that when the location for determination of the royalty is not specified in the lease, such royalty must be calculated "at the well."

venture between the lessor and lessee and the Statute does not impose joint liability for payment of the severance tax. *Burbank* remains good law and its precedent should be followed.

Just like oil and gas, the coal industry has been subjected to severance and processing taxes. Kentucky enacted a 4% coal severance tax in 1972 that was subsequently increased to 4½%. KRS 143.010 *et seq.* The coal severance and processing tax statute served as the model for KRS 143A.010 *et seq* and many of their provisions are virtually identical. KRS 143.020 levies a tax "on every taxpayer engaged in severing and/or processing coal." "Severing" the coal is defined as "the physical removal of coal from the earth." KRS 143.010(3). In 1977, a federal reclamation tax was imposed and in 1978 a federal black lung tax was enacted; each of which is imposed upon the severance of the coal.

In a case arising out of the Western District of Kentucky, the Sixth Circuit had an occasion to consider the deduction of the state and federal severance taxes. *Willits v. Peabody Coal Co.*, 188 F.3d 510 (6th Cir. 1999). The trial court denied the summary judgment motion of the royalty owner that Peabody could not deduct the severance taxes in the calculation and payment of the landowner royalties. The agreements provided for a royalty based upon a percentage of "gross realization" which was defined as "the gross selling price of all merchantable coal as invoiced F.O.B. the mine." The trial court submitted this issue to the jury who found for Peabody. The Sixth Circuit reversed and held, as a matter of law, that the deduction of the three severance taxes in the calculation of royalties due the landowner was not proper. See, also, *Hemenway v. Peabody Coal*

Co., 159 F.3d 255 (7th Cir. 1998), where the Seventh Circuit, applying Indiana law, held the two federally enacted severance taxes could not be deducted in calculating "sales price" on royalties due under the coal lease.

The two federal coal severance taxes and the Kentucky coal severance tax were the subject of *Reis v. Peabody Coal Co.*, 997 S.W.2d 49 (Mo. Ct. App. 1999), a Missouri case decided under the substantive law of Kentucky. The Missouri appellate court affirmed an award of punitive damages to the landowner based upon fraud in the improper deduction of severance taxes in the calculation and payment of royalties based upon "average monthly gross realization," which was defined as "sales price without deduction of sales commissions or expenses" due the Kentucky landowner. *Id.* at 54.

The royalties in *Willits* and *Reis* use "gross selling price" and "sales price" F.O.B. the mine. While these terms differ slightly from "market price at the well," they are virtually synonymous with one another. *Black's Law Dictionary*, 1308 (9th ed. 2009), defines "market price" as the price at which something is sold in a specific market. Both of these cases were decided under Kentucky law and each confirms that the Kentucky severance tax and the federally enacted severance taxes cannot be deducted in calculating royalties due the landowner.

West Virginia is in agreement. *Kanawha Valley Bank v. United Fuel Gas Co.*, 1 S.E.2d 875 (W.Va. 1939), involved an oil and gas lease where the royalty was based on "the wholesale market value thereof at the well." *Id.* at 876. The gas producer sought to recover a ratable share of the business tax from the landowner. In ruling for the landowner, the appellate court held that such a "deduction would be a material . . .

modification of the contract, a modification which the courts cannot sanction." *Id.* To the same effect, see, *Cole v. Pond Fork Oil & Gas Co.*, 35 S.E.2d 25 (W.Va. 1945); and *Estate of Tawney v. Columbia Natural Gas Resources, LLC*, 633 S.E.2d 22 (W.Va. 2006).

Enron Oil and Gas Co. v. State, Dept. of Natural Resources, Div. of State Lands and Forestry, 871 P.2d 508 (Utah 1994), involves a royalty clause and issue remarkably similar to the instant case. Enron agreed to pay the State a 1/8th royalty based on the "reasonable market value at the well" for gas with a floor of not less than that received by the United States. *Id.* at 509. The court points out "severance taxes are a cost of production for the producer" and holds that the severance taxes are to be included in "market value" upon which the royalty is required to be paid. *Id.* at 510.

There is no nexus between post-production costs and severance taxes. Severance taxes are imposed upon the severance of the gas from the earth which is part and parcel of the production process.

The "landowner's royalty" is "[a] share of production or revenues provided for the lessor in the royalty clause of the oil and gas lease and paid at the well <u>free of any costs of production.</u>" (Emphasis added.) *Black's Law Dictionary*, 1445 (9th ed. 2009). Ultimately, if it is determined that the landowner is required to bear a ratable share of the severance taxes, the Lease and/or Statute will have been rewritten and the royalty interest no longer will be free of the costs of production. Such judicial overreach has been condemned in Kentucky. *Gateway Construction Company v. Wallbaum*, 356 S.W.2d 247, 248-249 (Ky. 1962) ("it is neither the duty nor the prerogative of the judiciary to breathe into the statute that which the Legislature has not put there."); *Bennett v. Dudley,* 391 S.W.2d 375, 376-377 (Ky. 1965) ("The Court cannot make a new contract for the parties or revise their contract under profession of construing it."); *Plaza Condominium Association, Inc. v. Wellington Corp.,* 920 S.W.2d 51, 54 (Ky. 1996) ("it is not the function of the judiciary to change the obligations of a contract which the parties have seen fit to make.").

Under the Statute, the severance tax is unquestionably imposed upon the lessee. Case law, which has interpreted similar statutes, confirms that such tax should be borne by the lessee.

II. Fair And Reasonable Construction Of The Lease Disallows The Deduction Of Severance Taxes In The Calculation And Payment Of Royalties Based On "Market Price Of Gas At The Well."

An oil and gas lease is subject to the same rules of construction as ordinary contracts. *Oliver v. Louisville Gas and Electric Co.,* 732 S.W.2d 509 (Ky. App. 1987). Kentucky long has recognized that the cardinal rule in the construction of contracts is to ascertain the intention of the parties and give effect to such intention. This intention is to be gathered from the words that the parties employ in drafting their contract. *Siler v. White Star Coal Co.,* 226 S.W. 102 (Ky. 1920). The court "has no right to make a contract for the parties or revise the agreement while professing to construe it." *State Farm Mut. Auto. Ins. Co. v. Hobbs,* 268 S.W.2d 420, 422 (Ky. 1954). If the lease is ambiguous, the entire lease is to be construed in favor of the lessor and against the lessee. *Kies v. Williams,* 228 S.W. 40 (Ky. 1921).

The Question certified to this Court turns on the point where the severance tax is levied. The District Court suggests that the severance tax is simply another cost incurred after the gas leaves the wellhead and must be borne ratably by the landowner. Opinion at 5. Conversely, if such severance tax attaches prior to leaving the wellhead, it is a production expense and not deductible in calculation and payment of the landowner's royalty.

In Kentucky, the severance tax on gas is imposed upon "the physical removal of the natural resource [gas] from the earth." KRS 143A.010(3). Courts of the United States universally recognize that "removal from the earth" is the necessary act required for completion of production. See, e.g., *Diamond Shamrock Exploration Co. v. Hodel,* 853 F.2d 1159, 1168 (5th Cir. 1988) ("For purposes of royalty calculation and payment, production does not occur until the minerals are physically severed from the earth."); *Roye Realty & Developing, Inc. v. Watson,* 949 P.2d 1208, 1216 (Okla. 1996) ("produced" means "not only discovery of the product, but also extracting it from the ground."); *Killiam Oil Co. v. Bruni,* 806 S.W.2d 264, 267 (Tex. App. 1991) (defined "production" as "the actual physical extraction of the mineral from the soil;"); and *State v. Pennzoil Co.,* 752 P.2d 975, 979 (Wyo. 1988) ("'production' requires severance of the minerals from the ground;"); and *Energy Oils, Inc. v. Montana Power Co.,* 626 F.2d 731, 738 (9th Cir. 1980) ('"Production,' as used . . . in the oil and gas industry, refers to oil and gas actually severed from the ground.").

On the other hand, the term "post-production costs" refers to costs associated with making the natural gas marketable after the gas is severed or removed from the ground.

ConocoPhillips Co. v. Lyons, supra, 299 P.3d at 849-850; *Schroeder v. Terra Energy Ltd.*, 565 N.W.2d 887, 890, note 2 (Mich. Ct. App. 1997). In the instant case, the severance tax does not improve the quality or marketability of the gas, and it is imposed prior to leaving the wellhead. Such severance tax is not a post-production cost. Rather, it is a cost of production. See, e.g., *Enron Oil and Gas Co. v. State, Dept. of Natural Resources, Div. of State Lands and Forestry,* 871 P.2d 508 (Utah 1994) ("Severance taxes are a cost of production for the producer."); and *Public Service Co. of Colorado v. F.E.R.C.*, 91 F.3d 1478, 1481 (D.C. Cir. 1996) ("A severance tax is a cost imposed upon producing . . . a resource.").

Kentucky defines the royalty of the landowner as "compensation for the privilege or rights created by the lease." *McIntire's Administrator v. Bond,* 13 S.W.2d 772, 773 (Ky. 1929). *Black's Law Dictionary* at page 1445 confirms that the "landowner's royalty" is a share of the production or revenues "free of any costs of production." (9th ed. 2009.) Most leases, including the Lease under consideration herein, do not specify that the gas royalty is free of costs of production; however, "[f]reedom from such costs of production is implicit in the provision for payment of a share of the proceeds or value at the wellhead." *Creson v. Amoco Production Co.*, 10 P.3d 853, 860 (N.M. 2000), quoting from 3 Williams & Meyers, *Oil and Gas Law,* Sec. 643.2, p. 530.1; see, also, and *Schroeder,* 565 N. W.2d at 894. Finally, as noted by the *Poplar Creek* court, according to the lease "production costs, like those incurred drilling, operating and maintaining a well, as well as other costs incurred in order to extract gas from the earth and bring it up to the wellhead, are borne entirely by" the lessee. 636 F.3d at 239.

The Lease does not specify an allocation of the severance tax. The Lease provides for a gas royalty and such royalty is free of production costs. The severing of gas from the earth is part of the production process and such severance occurs prior to the gas leaving the wellhead. Ergo, the severance tax cannot be deducted in the calculation and payment of the landowner royalties based on "market price of gas at the well."

III. District Court Decision Is Contrary To Settled Kentucky Law.

The Opinion discusses the actions of the District Court in two instances where the reasons were advanced for holding that severance taxes could be deducted in calculation of gas royalties under the Lease.

A. The Kentucky Severance Tax is not a Post-Production Cost.

The trial court in the first instance references *Cartwright v. Cologne Prod. Co.,* 182 S.W.3d 438, 444-445 (Tex. Ct. App. 2006), and *Schroeder v. Terra Energy Ltd.*, 565 N.W.2d 887, 895 (Mich. Ct. App. 1997), and reasons:

> The Kentucky severance tax is simply another post-production cost that leads to a market price that is higher than the at-the-well price. Therefore, it is appropriate for EQT to deduct taxes, in addition to post-production costs, from market price to determine the at-the-well price—and then pay [Appalachian] royalties based [on] that price.
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> ***
>
> The payment of severance taxes is an expense required to bring the gas to market, and the expense is included in the ultimate market price. Therefore, it is reasonable to deduct severance taxes from the market price in order to 'work back' to calculate the at-the-well price.

(Opinion, p. 5.)

The initial thesis of the District Court is not correct and the cited cases do not support this proposition. Taxes based on the "processing" of the natural gas under KRS 143A.020 are imposed <u>after</u> the gas has been severed from the earth and left the wellhead. The same is not true for the severance tax. The severance tax is not another post-production cost. *Schroeder,* which did not involve any severance tax issue,[9] provides the accepted definition of "post-production costs:" "costs associated with making natural gas marketable after the gas is severed or removed from the ground." (Emphasis added.) 565 N.W.2d at 890 note 2; accord: *ConocoPhillips Co. v. Lyons,* 299 P.3d at 849-850. *Poplar Creek,* with citation to *Schroeder,* states that gathering, compression and treatment costs are "appropriately labeled post-production costs because these expenses are incurred after the gas leaves the wellhead." (Emphasis added.) *Poplar Creek* at 238-239. When the gas leaves the wellhead and is gathered, it already has been "severed from the earth"[10] and the severance tax has attached. KRS 143A.010(3) ("'Severing' or 'severed' means the physical removal of the natural resource from the earth . . . .").

The statute involved in *Cartwright*, Tex. Tax Code Ann., Sec. 201.051 *et seq,* imposes a severance tax on the producer. Sec. 201.001 defines "producer" to specifically include the owner of a royalty interest. The Texas severance tax is markedly different from the Kentucky statute which excludes the royalty owner. KRS 143A.010(8), amended July 1, 2013, to KRS 143A.010(4)(a) and (b).

[9] When *Schroeder* was decided in 1997, the Michigan severance tax, codified in MCL Sec. 205.303(1), was imposed upon the "producer," which Sec. 205.312(2) defines as a person who owns or is entitled to delivery of a share in kind or share of the monetary proceeds of oil or gas at the time of production or severance. The Michigan severance tax statute which includes the royalty owner is decidedly different from the Kentucky statute which specifically excludes the royalty owner from imposition of the tax. KRS 143A.010(4)(b).

[10] *Clay County v. Leslie County,* 531 S.W.2d 524 (Ky. 1975), a coal severance tax case, confirms that severance ("physical removal . . . from the earth") occurs when the natural resource departs from the formation where it was located, which is prior to the time the natural resource reaches the surface.

Before leaving *Cartwright,* it is noted that the opinion in such case indicates that "[w]hatever costs are incurred after production of the gas . . . are normally proportionately borne by both the operator and the royalty interest owners . . . [which] post-production costs include taxes . . . " (Emphasis added.) *Id.* 444-445. To the extent that such "include[d] taxes" refer to taxes associated with the processing or sale of the natural gas after it has left the wellhead, issue is not taken with such statement. However, "include[d] costs" do not include severance taxes inasmuch as such tax attaches prior to the completion of the production process. The failure of the Texas court to differentiate between severance taxes and processing taxes is of no consequence in Texas because by statute the severance tax is imposed upon the producer which by definition specifically includes the royalty owner.

In any event, *Poplar Creek* confirms that in Kentucky post-production costs "are incurred after the gas leaves the wellhead." *Poplar Creek* at 238-239. The severance tax is imposed upon the "physical removal of the natural resource from the earth" which occurs prior to the time the gas leaves the wellhead.

The severance taxes in effect in Michigan and Texas when *Schroeder* and *Cartwright* were decided include the royalty owner by specific definition. Similarly, in a number of other jurisdictions the legislatures have provided specifically that the severance tax should be borne by the producer or lessee and the royalty owner with the lessor in some instances being included by definition as a producer.[11]

[11] *Arkansas Natural Gas Co. v. Sartor*, 78 F.2d 924 (5th Cir. 1935), *Gibbs v. Southern Carbon Co.*, 171 So. 587 (La. Ct. App. 1937), and *Sartor v. United Carbon Co.*, 163 So. 103 (La. 1935), were all decided under Louisiana law. Since the 1920s, Louisiana has recognized that "royalty interests" are expressly included in the tax statute. La.R.S., Sec. 47:632; *Burbank v. Sinclair Prairie Oil Co., supra,* 424.

Schroeder, Enron, and *P.S.C. of Colorado* clearly confirm that the severance tax is not a post-production tax at all. Rather, it is a cost of production, and the landowner's royalty is free of the costs of production. *Creson v. Amoco Production Co.,* 10 P.3d at 860; *Poplar Creek,* 636 F.3d at 239.

B. The Lease Does Not Provide For Deduction Of Severance Taxes.

In the second instance, the Opinion quotes the District Court where it indicates the issue is not whether the law requires ALC to pay a portion of the severance taxes: "The issue here is whether the contract between EQT and [Appalachian] allows EQT to deduct a portion of the severance tax it pays from the ultimate sales price in order to calculate the market price at-the-well." Opinion at 6. The Opinion continues with an explanation and justification proffered by the trial court:

> Under the lease, EQT would be prohibited from deducting severance taxes if EQT paid those severance taxes based on the price of gas "at-the-well." But, the taxes are paid at the market price, which is higher than the at-the-well price. Therefore, it is permissible to deduct severance taxes, as well as other postproduction costs, from the market price in order to "work back" to calculate the at-the-well price.

The parties are free to provide in their lease the responsibility for payment of the Kentucky severance tax. This was done in *Poplar Creek,* 636 F.3d at 245 note 5. However, in the instant case there was no parsing of this responsibility and the District

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In *Gulf Refining Co. v. Stone,* 21 So.2d 19, 21 (Miss. 1983), the court noted "the legislative declaration that the royalty holder shall share in the burden of the [severance] tax is based upon reason, it is not subject to rejection by a court." The Michigan severance tax statute defines producer to include anyone entitled to receive a royalty, and the court in *Brown v. Shell Oil Co.,* 339 N.W.2d 709, 713 (Mich. App. 1983), upheld dismissal because the severance tax included royalty owners "as a matter of law as producers who must pay their share of the tax." Likewise, in *Hockett v. Trees Oil Co.,* 251 P.3d 65, 68 (Kan. 2011), the severance tax defines "producer" to include "any person owning any direct and beneficial interest in coal, oil or gas . . . including a royalty interest."

oil and gas producing jurisdictions. *Rogers v. Westerman Farm Co.,* 29 P.3d 887, 901 (Colo. 2001) ("we are mindful of the generally accepted rule that oil and gas leases are strictly construed against the lessee in favor of the lessor."). The reason for the rule is aptly stated in *Gilmore v. Superior Oil Co.,* 388 P.2d 602, 603 (Kan. 1964):

> Construction of oil and gas leases containing ambiguities is in favor of the lessor and against the lessee for the reason that the lessee usually provides the lease form or dictates the terms thereof and if such lessee is desirous of more complete coverage, the lessee has the opportunity to protect itself by the manner in which it draws the lease.

It is submitted that reasonable minds do not differ in the calculation and payment of gas royalties based on "market price of gas at the well" - severance taxes cannot be deducted. However, if there is any doubt, such doubt must be resolved in favor of the lessor, ALC.

CONCLUSION

For the reasons set forth above, the Question certified to this Court should be answered as follows:

> Kentucky's "at-the-well" rule does not allow a natural gas producer to deduct severance taxes prior to calculating and paying the contractual royalty based on "market price of gas at-the-well."

Under the assumed \$2.00 per MCF "at-the-well" price, the royalty due the landowner under the Lease should be based on $1/8^{th}$ of \$2.00 and not on $1/8^{th}$ of (\$2.00 x 95.5%).

Respectfully submitted,

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